6993
Q35290

K 99-2810

FORM 10 Q

SECURITIES AND EXCHANGE COMMISSION
WASHINGTON, D.C. 20549

(Mark One)
[X] QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) of the SECURITIES EXCHANGE ACT OF 1934
For the quarterly period ended June 30, 1992
OR
[ ] TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) of the SECURITIES EXCHANGE ACT OF 1934
For the transition period from _____ to_____

Commission File Number 0-9691

Network Systems Corporation

(Exact name of registrant as specified in its charter)

Delaware	41-1231031
(State or other jurisdiction of incorporation or organization)	(I.R.S. Employer Identification No.)

7600 Boone Avenue North, Minneapolis, Minnesota 55428

(Address of principal executive offices) (Zip Code)

612-424-4888

(Registrant's telephone number, including area code)

Not Applicable

(Former name, former address and former fiscal year, if changed since last report)

Indicate by check mark whether the registrant (1) has filed all reports required to be filed by Section 13 or 15(d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes X No__.

30,292,504 shares of common stock
Par value $.02 per share, were outstanding as of
August 7, 1992

Microfilmed
By
Q-Data
Corporation
St. Petersburg, FL

NETWORK SYSTEMS CORPORATION

INDEX

	Page Number
PART I. FINANCIAL INFORMATION:	
Item 1. Condensed Consolidated Financial Statements	
Condensed Consolidated Balance Sheets June 30, 1992 (unaudited) and December 31, 1991	3
Condensed Consolidated Statements of Income Three months and six months ended June 30, 1992 and 1991 (unaudited)	4
Condensed Consolidated Statements of Cash Flows Six months ended June 30, 1992 and 1991 (unaudited)	5
Notes to Condensed Consolidated Financial Statements	6-7
Item 2. Management's Discussion and Analysis of Financial Condition and Results of Operations	8-15
PART II. OTHER INFORMATION	16-17

NETWORK SYSTEMS CORPORATION
CONDENSED CONSOLIDATED BALANCE SHEETS
(In thousands)

ASSETS	June 30, 1992 (Unaudited)	December 31, 1991 (Note)
Cash and short-term investments	$ 55,456	$ 59,308
Marketable securities	7,441	9,225
Accounts receivable, net	64,134	64,962
Notes receivable from officers	1,626	265
Interest and other receivables	3,474	3,408
Inventories	20,645	25,051
Other current assets	10,733	10,387
Total current assets	163,509	172,606
Property, plant, and equipment, at cost	86,723	78,575
Less accumulated depreciation	47,895	41,493
Net property, plant, and equipment	38,828	37,082
Marketable securities	62,050	52,494
Goodwill and other intangible assets, net of accumulated amortization of $3,589 (1991-$1,960)	50,029	51,658
Notes receivable from officers		1,756
Software development, less accumulated amortization of $9,747 (1991-$7,983)	5,214	5,478
Other assets, net	23,018	21,737
Total other assets	140,311	133,123
	$ 342,648	$ 342,811
LIABILITIES AND STOCKHOLDERS' EQUITY		
Accounts payable	$ 4,572	$ 7,265
Accrued liabilities	27,036	28,990
Income taxes payable	5,692	6,286
Deferred revenue	2,000	2,000
Current maturities of long-term debt	37	37
Total current liabilities	39,337	44,578
Deferred revenue	2,500	3,500
Long-term debt	2,805	2,822
Deferred compensation	9,077	8,151
Deferred income taxes	2,940	2,940
Other long-term liabilities	6,047	6,677
STOCKHOLDERS' EQUITY		
Common stock	605	603
Additional paid-in capital	116,647	116,496
Retained earnings	158,060	152,578
Cumulative translation adjustment	4,630	4,466
Total stockholders' equity	279,942	274,143
	$ 342,648	$ 342,811

(Note) The balance sheet at December 31, 1991, has been taken from the audited financial statements and condensed.

NETWORK SYSTEMS CORPORATION
CONDENSED CONSOLIDATED STATEMENTS OF INCOME
(In thousands except per-share amounts)
(Unaudited)

	Three months ended June 30,		Six months ended June 30,	
	1992	1991	1992	1991
Revenues:				
Net sales - products	$ 37,332	$ 32,268	$ 70,246	$ 53,328
Services	16,797	13,098	32,594	25,642
Total revenues	54,129	45,366	102,840	78,970
Costs and expenses:				
Cost of sales	14,622	11,957	27,833	19,164
Cost of services	10,924	9,151	21,385	18,429
Marketing, general, and administrative	17,242	14,268	34,139	27,177
Research and development	6,243	4,840	12,190	9,230
Costs of acquistion		3,974		3,974
Amortization of intangibles	815	300	1,629	300
Total costs and expenses	49,846	44,490	97,176	78,274
Income from operations	4,283	876	5,664	696
Interest:				
Income	2,022	3,577	3,874	7,140
Expense	<295>	<350>	<586>	<658>
Net interest income	1,727	3,227	3,288	6,482
Income before income taxes	6,010	4,103	8,952	7,178
Income taxes	2,340	1,370	3,470	2,460
Net income	$ 3,670	$ 2,733	$ 5,482	$ 4,718
Net income per common and common equivalent share	$ .12	$ .09	$ .18	$ .16
Average common and common equivalent shares	30,934	30,200	31,164	30,100

NETWORK SYSTEMS CORPORATION
CONDENSED CONSOLIDATED STATEMENTS OF CASH FLOWS
(In thousands)
(Unaudited)

	Six months ended June 30,	
	1992	1991
Cash flows from operating activities:		
Net income	$ 5,482	$ 4,718
Adjustments to reconcile net income to cash provided from operating activities:		
Depreciation and amortization	6,300	4,769
Amortization of software development	1,764	1,695
Amortization of intangibles	1,629	300
<Increase> decrease in assets	3,543	<21,347>
Increase <decrease> in liabilities	<6,030>	30,951
Net cash flows provided <absorbed> by operations	12,688	21,086
Cash flows from investing activities:		
Cost of company acquired, net of cash acquired		<53,618>
<Increase> decrease in marketable securities	<6,740>	25,489
Purchases of property, plant, and equipment		
Additions to software development	<8,701>	<11,677>
Reduction of notes receivable	<1,500>	<1,830>
Net cash flows <used in> investing activities	395	125
	<16,546>	<41,511>
Cash flows from financing activities:		
Proceeds from short-term bank loan		45,000
Proceeds from issuing common stock to employees	2,726	1,064
Repurchase of common stock	<2,573>	
Issuance of stock options at a discount in connection with the acquisition of Vitalink		4,410
Repayment of debt	<18>	<16>
Net cash flows provided by financing activities	135	50,458
Effects of exchange rate changes	<129>	1,876
Increase <decrease> in cash and short-term investments	<3,852>	31,909
Cash and short-term investments at beginning of period	59,308	64,439
Cash and short-term investments at end of period	$ 55,456	$ 96,348

NETWORK SYSTEMS CORPORATION
NOTES TO CONDENSED CONSOLIDATED FINANCIAL STATEMENTS
SIX MONTHS ENDED JUNE 30, 1992

(Unaudited)

1. CONDENSED CONSOLIDATED FINANCIAL STATEMENTS

The condensed consolidated balance sheet as of June 30, 1992, the condensed consolidated statements of income for the three- and six-month periods ended June 30, 1992 and 1991, and the condensed consolidated statements of cash flows for the six-month periods then ended have been prepared by the Company without audit. In the opinion of management, all adjustments (which include only normal recurring adjustments) necessary to present fairly the financial position, results of operations and cash flows at June 30, 1992, and for all periods presented have been made.

Certain information and footnote disclosures normally included in financial statements prepared in accordance with generally accepted accounting principles have been condensed or omitted. It is suggested that these condensed consolidated financial statements be read in conjunction with the financial statements and notes thereto included in the Company's December 31, 1991, annual report to shareholders. The results of operations for the period ended June 30, 1992, are not necessarily indicative of the operating results for the full year.

2. INVENTORIES

Inventories consist of the following (in thousands):

	June 30, 1992	December 31, 1991
	(In thousands)	
Raw material	$ 6,789	$ 6,745
Work in process	7,326	11,175
Finished goods	6,530	7,131
	$ 20,645	$ 25,051

3. STOCKHOLDERS' EQUITY (In thousands)

	Common Stock	Additional paid-in capital	Retained earnings	Cumulative translation adjustment	Total
Balances at December 31, 1991	$ 603	$ 116,496	$152,578	$ 4,466	$ 274,143
Issuance of common stock upon exercise of stock options	7	2,432			2,439
Issuance of common stock through employee stock purchase plan		246			246
Nonqualified discount options considered earned compensation		41			41
Repurchase and retirement of common stock	<5>	<2,568>			<2,573>
Change in cumulative translation adjustment				164	164
Net income			5,482		5,482
Balances at June 30, 1992	$ 605	$ 116,647	$158,060	$ 4,630	$ 279,942

Item 2. MANAGEMENT'S DISCUSSION AND ANALYSIS OF FINANCIAL CONDITION AND RESULTS OF OPERATIONS

Results of Operations

Revenues from net product sales increased 16 and 32 percent for the three-month and six-month periods ended June 30, 1992, when compared with the same periods in 1991. Revenue from services increased 28 and 27 percent in the three-month and six-month periods, resulting in an overall increase in total revenues of 19 and 30 percent, respectively. When compared with the same periods for 1990, revenues from product sales had increased 12 percent for the three-month period ended June 30, 1991 and remained relatively unchanged for the six-month period ended June 30, 1991. Revenues from services had increased 13 percent in both periods, and total revenues had increased 12 and 4 percent, respectively. When comparing 1992 with 1991 the Company's acquisition of Vitalink Communications Corporation ("Vitalink") in June, 1991 should be considered. The Company's 1992 consolidated financial statements include Vitalink's operating results for the entire three- and six-month periods as opposed to the Company's 1991 consolidated financial statements when Vitalink's operating results are included for the month of June only.

In 1992 Vitalink contributed product revenues of $7,927,000 for three months and $14,484,000 for the six months. Vitalink product revenues contributed $4,480,000 for the 1991 three- and six-month periods. Service revenues contributed by Vitalink are $2,268,000

for three months and $4,766,000 for six months 1992 compared with $592,000 for the three- and six-month periods of 1991.

Hardware sales increased 32 percent in the second quarter and 47 percent for the first six months of 1992 when compared with the same 1991 periods. Hardware sales accounted for 59 and 57 percent of total revenues for the 1992 three- and six-month periods. This compares with 53 and 51 percent for the same periods in 1991. Licensing of software, the sale of monthly contracts for software license fees, $500,000 in March 1992 and $2,000,000 in June 1991, and other income provided the balance of net product sales. This balance of net product sales contributed 10 and 11 percent of total revenues in the 1992 three- and six-month periods versus 18 and 17 percent for the same periods in 1991. Service revenues from maintenance contracts on the Company's installed equipment provided 31 and 32 percent of total revenues for the three- and six-month periods of 1992 compared with 29 and 32 percent for 1991.

Vitalink's revenues have principally come from sales of products called remote bridges, which are used to interconnect geographically dispersed local area networks. Vitalink has installed more than 20,000 of these bridges in over 1800 customer sites. The Company expects that sales of these products will add to the Company's revenues in 1992 and 1993, but will ultimately be replaced by the Company's new line of bridge/routers, which provide

more performance and functionality. Vitalink's installed base will also contribute to the Company's service revenues.

Quarterly revenues and operating results depend on the volume and timing of customer orders received during the quarter, which are difficult to forecast; therefore, the Company may experience fluctuations in quarterly results. The Company believes its ability to increase revenues will depend on the success of its internetworking products, the continued growth of HYPERchannel-DX sales, and on its ability to manufacture the proper configurations for shipments when required. The Company's operating results may also be adversely affected by general economic conditions such as a recessionary period affecting the computer sector of the economy.

A breakdown between domestic and international revenues shows that domestic revenues provided an increasing share of the total. For the three- and six-month periods of 1992, domestic revenues provided 60 and 59 percent of total revenues compared to 59 and 55 percent for same periods of 1991. International revenues were 40 and 41 percent for the 1992 periods and 41 and 45 percent for the respective 1991 periods. The increase in domestic revenues is a result of the addition of Vitalink's revenues, which were largely domestic. Without Vitalink's revenues, the relationship of domestic and international revenues between 1992 and 1991 is not significantly different.

The ratio of product costs as a percentage of product sales increased by 2 and 4 percent for the three- and six-month periods of 1992 when compared with the same periods of 1991. For 1991, this ratio had increased by 4 and 3 percent for the three- and six-month periods of 1991 when compared with the same periods of 1990. The trend of increasing product costs since 1990 reflects higher initial product costs for the introduction of more new products than for any previous period in the Company's history. In addition, the Company has been in the process of changing its manufacturing processes to improve product quality and to reduce the level of inventory required to fill orders received near the end of a quarter. The Company believes that increases in new product volume, generally lower material costs, and completion of manufacturing process changes will result in lower product costs beginning later in 1992.

The ratio of the cost of services as a percentage of service revenues decreased by 5 percent in the second quarter and 6 percent for the first six months of 1992. A comparison of the 1991 cost of services ratio with the same periods in 1990 shows a decrease of 1 percent in the second quarter and an increase of 2 percent for the six months. For the remainder of 1992, the Company expects some pressure on service revenue growth, which would result in an increase in the cost of services as a percentage of service revenues. Additional service revenues as a result of the Vitalink acquisition could partially offset the slower revenue growth.

Marketing, general, and administrative expenses are 32 and 33 percent of total revenues for the three- and six-month periods in 1992. This compares with 31 and 34 percent for 1991 and 33 and 34 percent for 1990. In addition, costs associated with the acquisition of Vitalink differ in 1992 from 1991. The Company incurred a charge for amortization of intangibles of $815,000 for the three months and $1,629,000 for the six months of 1992. For 1991, in addition to $300,000 charged for one month's amortization of intangibles, the Company also incurred a one-time charge of $3,974,000 for costs associated with the June 1991 acquisition. Amortization of intangibles are 2 percent of total revenues for both the three- and six-month periods of 1992. Amortization of intangibles along with the one-time charge for acquisition costs are 9 and 5 percent of total revenues for the respective three- and six-month periods of 1991. Amortization of intangibles will continue at reduced amounts over the 2 to 20 year lives assigned to intangible assets. For 1992, the amortization of intangibles will be approximately $3,300,000.

Research and development costs accounted for 12 percent of total revenues for both the three- and six-month periods of 1992, compared with 11 and 12 percent of total revenues for the respective periods of 1991. The Company anticipates it will be required to continue making significant investments in product developments to keep pace with technological advancements in the

networking field. Total research and development expenditures for the year 1992 are expected to be greater than for the year 1991.

Net interest income, including capital gains, was $1,727,000 and $3,288,000 in this year's second quarter and six months. This compares with $3,227,000 and $6,482,000 in the respective 1991 periods. The most significant factor affecting the reduction in interest income is the over $50 million reduction of average invested cash balances since the June 1991 acquisition of Vitalink. In addition to the reduction of the average invested cash balances, the Company's interest returns are reflecting the trend of lower interest rates.

The Company's income taxes were provided at effective income tax rates of 38.9 and 38.8 percent for the three- and six-month periods of 1992. This compares with effective income tax rates of 33.4 percent for the three months and 34.4 percent for the six months of 1991. The most significant factor that increased the Company's estimate of its 1992 effective tax rate over its 1991 effective tax rate is the additional non-deductible goodwill amortization. The Company reviews the effective income tax rate quarterly and could make minor adjustments to reflect changing estimates.

In May 1991, the Company paid approximately $11,000,000 to the Internal Revenue Service ("IRS") for the assessment of an accumulated earnings tax imposed on the Company by the IRS for the

tax years 1983 through 1985. The Company took this action to preserve its option to contest the issue in Federal District Court. The Company and its special tax counsel believe that the IRS position is substantially without merit. Accordingly, the Company has made no provision with respect to this matter, and the amount paid is considered a long-term deposit that will bear interest at the IRS refund rate.

Liquidity and Capital Resources

Cash and short-term investments and marketable securities increased $3.9 million during the six months ended June 30, 1992, to a level of $124.9 million. Operating activities contributed $13.6 million; financing activities, largely the sale of stock to employees, were substantially offset by the repurchase and retirement of $2.6 million of the Company's stock, resulting in a net contribution of $.1 million; net investing activities used approximately $9.8 million for the addition of equipment and for capitalized software development expenditures, while repayment of officer notes receivable provided cash.

The Company believes its cash and relatively liquid investments totaling $124.9 million at June 30, 1992, $5.0 million of local currency lines of credit available to its foreign subsidiaries, and cash flows anticipated from operations, with only a minor amount of long-term debt, provide the capital resources required by its operations for 1992. The Company believes that this liquidity,

together with cash flows from operations, will meet its 1992 operating requirements, fund an additional payment of potential tax assessments, and position the Company to use its funds for investments in a business opportunity should it become available in 1992.

PART II

OTHER INFORMATION

Item 1. Legal Proceedings.

None.

Item 2. Changes in Securities.

Not applicable.

Item 3. Defaults Upon Senior Securities.

Not applicable.

Item 4. Submission of Matters to a Vote of Security Holders

(a) Date of meeting -- May 13, 1992
-- Annual Stockholders' Meeting

(b) Not applicable.

(c) Matters voted upon.

To elect three Directors for
a term of three years.

(d) Not applicable.

Item 5. Other Information.

Not applicable.

Item 6. Exhibits and Reports on Form 8-K.

(a) Exhibits.

None.

(b) Reports.

None.

SIGNATURES

Pursuant to the requirements of the Securities Exchange Act of 1934, the registrant has duly caused this report to be signed on its behalf by the undersigned thereunto duly authorized.

NETWORK SYSTEMS CORPORATION

/s/Richard A. Fisher
(Registrant)

Date: August 7, 1992

Richard A. Fisher, Vice
President and Treasurer
(Authorized Officer and
Principal Financial Officer)